Internal Revenue Service
memorandum
CC:TL-N-5318-89
Brl:HMLewis

date: MAY 22 1989

to: District Counsel, Greensboro, N.C. CC:GBO
Attn: James R. Rich

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]
Year: Form 1065 for [redacted]

This is in response to your memorandum dated March 23, 1989, requesting Tax Litigation Advice with respect to the above named taxpayer.

ISSUES

(1) Where a written partnership agreement dated [redacted], specifies that net profits and net losses are to be allocated equally between [redacted] partners, and [redacted] of the partners contributes [redacted] percent of the capital of the partnership in [redacted] and [redacted] percent in [redacted] and where the partners claim partnership losses on their individual income tax returns for [redacted] and [redacted] in proportion to their capital contributions, should the allocation set forth in the partnership agreement be respected under I.R.C. § 704 for federal income tax purposes?

(2) Where a written partnership agreement dated [redacted], specifies that net profits and net losses are to be allocated equally between [redacted] partners, and the partnership files a [redacted] return allocating a loss in proportion to the partners' capital contributions, but the return reflects that profits are to be shared equally, is the partnership within the "small partnership" exception of section 6231(a)(1)(B)?

(3) Where a written partnership agreement dated [redacted], states that capital contributions, profits, and losses are to be shared equally between the only [redacted] partners of a partnership with no mention being made in the partnership agreement as to services, and where [redacted] partner in [redacted] contributes [redacted] percent of the total capital to the partnership and also his services and claims a loss (on his [redacted] income tax return) attributable to the partnership in proportion to his capital contribution, has that partner received a profits interest, and should he be taxed on the value of his profits interest under section 721?

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CONCLUSIONS

(1) It would not be appropriate to require the partnership to make its [redacted] allocations in accordance with the original partnership agreement when the allocations made by the partnership under its alleged modification more closely reflect the partners' interests in the partnerships.

(2) It appears that the partnership is not within the small partnership exception of section 6231(a)(1)(B) because of a disproportionate allocation. However, the facts and circumstances must be analyzed to determine whether this disproportionate allocation meets one of the exceptions from the same share requirement.

(3) Even if [redacted] partner received an interest in future partnership profits as compensation for services, we do not recommend that partner be charged with taxable income in [redacted].

FACTS

[redacted], a partnership, was formed in [redacted], by [redacted] and [redacted] The partnership was formed to acquire and develop a [redacted] farm. The partnership [redacted], and [redacted].

The partnership agreement (hereinafter, the agreement) states that it is made and entered into as of the [redacted] day of [redacted], by and among [redacted], [redacted] and [redacted]. (The revenue agent orally stated that [redacted] and [redacted] did not contribute anything to the partnership and that, at least in [redacted], they were not considered by her to be partners.) The agreement provides that [redacted] and [redacted] each shall contribute to the capital of the partnership the sum of $[redacted], for a total capital contribution of $[redacted]. The agreement further provides that additional contributions to the capital of the partnership may be necessary, and that such contributions shall be made by the parties to the agreement in the ratios in which profits and losses are shared pursuant to the agreement.

The agreement provides that net profits and net losses of the partnership shall be shared on an equal basis ([redacted]% each) by [redacted] and [redacted]. Distributions, including distributions in net proceeds derived from the sale of the partnership's property, are to be made to the partners in the ratios in which profits and losses are shared.

The agreement states that it constitutes the entire understanding among the parties and supersedes any prior written or oral agreements among the parties with regard to the matters covered in the agreement. The agreement states the it may be modified by majority vote with each partner having [redacted] of the partnership's profits and losses allocated to such partner at that time; provided, however, that provisions of this agreement relating to a partner's share of profits, losses and capital may be modified only by unanimous consent of all partners.

The partnership agreement was submitted to the examining revenue agent on [redacted]. On [redacted], the partnership submitted to the examining revenue agent a second document entitled "PARTNERSHIP AGREEMENT." According to the examining revenue agent, this second partnership agreement (hereinafter referred to as the second agreement) is actually an amendment of the first partnership agreement and was submitted to justify the allocation of the loss on the [redacted] partnership return. This second agreement states that it is made, entered into, and effective the [redacted], by and between [redacted] and [redacted]. This second agreement differs from the first agreement in several respects.

The second agreement provides that [redacted] has a [redacted] percent partnership interest and that [redacted] has a [redacted] percent partnership interest. It also states that the initial capital contribution of each partner shall be $[redacted] for [redacted] and $[redacted] for [redacted]. The second agreement provides that the business and purpose of the partnership will be accomplished through the use of loan financing and partner capital contributions. Any additional capital contributions are to be made in proportion to the partnership interests. Profits and losses of the partnership are to be shared and allocated annually among the partners in the same ratio as the partnership interests ([redacted]. The second agreement further provides that it is the intent of the partners that the allocation of profits and losses under the agreement shall have substantial economic effect within the meaning of section 704(b). The second agreement states that no amendments or modifications to the terms of the agreement can be made unless in writing and signed by each of the partners.

Although this second partnership agreement is dated [redacted], it was not submitted to the examining revenue agent until [redacted]. The revenue agent states that agreement was presented to justify the allocation of losses shown on the partnership return for the [redacted] year. [redacted] used his [redacted] percent of the loss to offset other income on his [redacted] income tax return. [redacted] had little outside income against which to offset his [redacted] percent of the loss.

The partnership also submitted to the examining revenue agent a copy of a memorandum dated [redacted], from "[redacted]" to "[redacted]". The document is entitled "[redacted]," and according to the examining revenue agent is a memorandum written by the partnership's lawyer. The first paragraph of this memorandum states that it is the understanding of the writer that the partnership ([redacted]) submitted Schedules K-1 (Form 1065) to the partners based upon partnership loss allocation percentages different from those contained in their partnership agreement. The memorandum goes on to address the question of the proper allocation the partners should take for purposes of proper tax return preparation. This memorandum states that it appears that the partners of [redacted] intended to amend their written partnership agreement as manifested by their acceptance of, or failure to object to, the Schedules K-1 submitted for the preparation of their income tax returns. This memorandum also states that review of the partnership agreement may reveal a provision requiring amendments to the partnership agreement to be made in writing, and if that be the case, it may be necessary for the partners to immediately execute an amendment to the partnership agreement documenting the partners' intent to amend the agreement as of the first day of its existence. (The [redacted] partnership agreement does not have a provision requiring amendments to the partnership agreement to be in writing.)

The partnership return for its [redacted] year showed a loss of $[redacted]. [redacted] claimed the entire amount of the loss. On its income tax return for the year [redacted], the partnership showed a loss of $[redacted]. [redacted] and [redacted] filed their [redacted] income tax returns and reported their partnership losses from [redacted] based on the Schedules K-1 from the partnership. The Schedules K-1 showed ordinary losses of $[redacted] for [redacted] and $[redacted] for [redacted].

We note that the [redacted] partnership return shows a long-term capital gain of $[redacted] and that entire gain was allocated to [redacted] on his [redacted] Schedule K-1. No information on this allocation was provided, and we do not know whether this allocation was made by the partnership based on the agreement or a modified agreement or whether it was required by the Code. (For example, section 704(c) may require a partner who contributes property that has a variation between the basis of the property to the partnership and its fair market value at the time of contribution to take that difference into account when allocations concerning that property are made.)

We also note that on the [redacted] Schedules K-1 for [redacted] and [redacted], Question D provides that each has a profits sharing interest of [redacted] percent at the end of the year. The "Loss sharing" and "Ownership of capital" percentages were not entered.

The partnership is taking the position that the partnership agreement was modified orally in [redacted]. The partnership's position is that the terms of the oral modification were reduced to writing after the filing of the partners' [redacted] returns and after the filing of the [redacted] partnership return. The modification was approved by all of the partners, including [redacted] and [redacted]. The partnership points to the allocation of losses on the [redacted] Schedules K-1 as evidence of the oral modification. The revenue agent informs us that the partners stated that their names ([redacted] and [redacted]) never should have been on the original partnership agreement.

DISCUSSION

For purposes of this Tax Litigation Advice memorandum, we are addressing your specific requests. We are assuming that there is a valid partnership for federal tax purposes, that [redacted] was a partner and not an employee or independent contractor, that the partnership is engaged in a trade or business with a profit motive, and that the partnership's activities possess economic substance and business purpose (i.e., it is not a tax sham).

ISSUE 1 - Proper Allocation of Gain or Loss Under Section 704

Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall be determined by the partnership agreement. Treas. Reg. § 1.704-1(a) provides, in part, that a partnership agreement is defined in section 761(c).

Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking all the facts and circumstances), if -

(1) the partnership agreement does not provide as to the partnership's distributive share of income, gain, loss, deduction, or credit (or item thereof), or
(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Section 761(c) provides for purposes of this subchapter that a partnership agreement includes any modifications of the partnership agreement made prior to or at the time prescribed for the filing of the partnership return for the taxable year (not including extensions), which modifications are agreed to by all the partners, or which are adopted as provided by the partnership agreement.

Treas. Reg. § 1.761-1(c) provides that such agreement or modification can be oral or written. As to any matter on which the partnership agreement, or any modification is silent, the provisions of local law shall be considered to constitute a part of the agreement.

Thus, the analysis begins by determining what the partnership agreement provided concerning allocations of gain and losses for the year [redacted].

The original partnership agreement provided that [redacted] and [redacted] were each to provide $[redacted] as an initial capital contribution. Net profits or net losses of the partnership were to be shared equally. Further, additional contributions, if needed, were to be made in the ratios that profits and losses were shared.

The partnership alleges that this agreement was modified orally in [redacted] to provide that [redacted] was to receive [redacted] percent of the net profits or net losses and [redacted] was to receive [redacted] percent of the net profits or losses.

In Ringel v. Commissioner, T.C. Memo. 1961-163, the Tax Court considered a situation in which Ringel and Rinaldi had formed a partnership with each initially contributing $6,000 as capital. They provided in a written agreement that further capital contributions shall be equal and that they would share net profits and losses equally. Ringel became dissatisfied and drew up a new partnership agreement which changed the capital accounts sharing and gave Ringel 75 percent of the profits or losses. Rinaldi signed the agreement and twenty months later the partnership was dissolved. Ringel instructed the accountant to prepare the last partnership return showing a distribution to the partners on a 50-50 basis.

The Tax Court agreed with the Service that Ringel's distributive share was 75 percent. The Tax Court noted that the first return prepared after the modification showed Ringel's distributive share as 75 percent and Rinaldi's share as 25 percent. The Tax Court noted that Ringel acted in other matters as if he had a 75 percent interest.

In Schmitz v Commissioner, T.C. Memo. 1978-317, a father and his two sons were equal partners in a cattle ranch. Prior to the father's death in 1958, they orally agreed that the sons would pay their mother 20 percent of the gross proceeds of steer sales upon the death of the father. The Service asserted that payments made to the mother in 1972 and 1973 by the partnership were not obligations of the partnership but were support payments by the son, the petitioner.

The Tax Court in Schmitz found that the mother, under state law and the father's will, inherited the father's partnership interest but that the oral agreement modified her interest to the limited 20 percent interest rather than a full one-third interest. The Tax Court noted that the mother received payments from 1958 through 1976 for this 20 percent interest and that the mother reported her share from the partnership as income. See also James v. Commissioner, T.C. Memo. 1962-173 and Minkoff v. Commissioner, T.C. Memo. 1956-269, in which the Tax Court allowed oral modifications to govern written agreements and found that petitioners' intentions were indicated by allocations in tax returns.

However, in Kresser v. Commissioner, 52 T.C. 1621 (1970), the Tax Court found that an alleged modification to an oral partnership agreement was ineffective under section 761(c) to alter the agreement because it was not agreed to by all the partners or in a manner provided by the partnership agreement. In Kresser, the petitioners were partners since 1960 in two partnerships with William Appleton, the promoter and dominant partner. In 1965, Appleton proposed a modification of the agreement so that all the income from the partnership for 1965 would be allocated to Appleton because he had an expiring net operating loss carryover. All income after 1965 would be allocated to the other partners until such time as the amounts of partnership income allocated to Appleton in 1965 had been restored to the other partners.

The Tax Court found that not all the partners had been notified about the modification so that he first condition of section 761(c) concerning agreement by all partners was not met. Further, it found that the petitioners failed to show whether the oral agreement had provided a method for adopting modifications and whether such method had been followed. The Tax Court stated that the petitioners failed to call Appleton, the dominant partner, or other partners to testify. The Tax Court assumed that the information that would have been provided would not be in the petitioners' best interest or it would have been presented.

Further, the Tax Court found that the 1965 allocation of income to Appleton was nothing more than a paper transaction having no consequences of substance, and did not represent a true modification or readjustment of the partner's distributive share of income.

In Tapper v. Commissioner, T.C. Memo. 1986-597, the petitioner was a general partner in a limited partnership that was to construct a post office facility, which was having large cost overruns. The partnership agreement stated that it could not be changed orally. In 1978, the post office was sold to the federal government and the partnership was to be dissolved. In a letter the partnership advised each general partner that any general partner contributing more than his proportionate share would be entitled to special allocation of tax benefits equal to double the amount of the excess contribution. The reverse would apply to a partner who was short of his required contribution. The petitioner made such excess contribution and claimed the special allocation.

The Tax Court in Tapper found that the petitioner had not presented evidence sufficient to satisfy the burden of proving that anyone other than the petitioner ever agreed to the proposed reallocation. The Tax Court stated that the partnership return submitted as evidence was not signed and there is no evidence that the Schedules K-1 were ever approved by the other affected general partners. The Tax Court found it significant that the petitioner had not called the other general partners to testify. Thus, the Tax Court rejected the oral modification of the partnership agreement.

We believe the facts in the instant case are closer to the facts in Ringel, Schmitz, James, and Minkoff than to the facts in Kresser and Tapper. In the instant case, the partnership agreement does not require the modification to be oral. We are not aware of any North Carolina law that requires such modification to be in writing. There are only [redacted] partners involved and it appears that it would not be difficult for them to prove that at some time before [redacted], they orally agreed to modify the original agreement. It appears that they will probably claim that the oral modification took place before [redacted], the date the [redacted] partnership return was due.

They can also claim that their actions between themselves and with the Service support the modification. The revenue agent states [redacted] furnished all the capital in [redacted] and $[redacted] in [redacted] while [redacted] furnished capital of $[redacted] in [redacted].1/ If the partnership agreement were not modified, [redacted] would be required to contribute [redacted] percent of the capital. Further, the partnership filed its [redacted] and [redacted] federal tax returns in accordance with the modification.

This situation differs from Kresser and Tapper in that the modification has economic effect and is not the trading of the tax benefits in a paper transaction. [redacted], under the modification, will receive [redacted] percent of the net profits but will also be responsible for paying [redacted] percent of the debts for not only [redacted] and [redacted] but also all future years unless modified again. However, in Kresser and Tapper, the partners were either switching income from one year to another among themselves

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1/ The [redacted] Schedule K-1 for [redacted] states that his capital account at beginning of year was $[redacted] and that he contributed $[redacted] during [redacted].

without changing the basic agreement from one year to another or buying known tax benefits.

Thus, based on the submitted facts, we believe that the oral modification should be given effect. We acknowledge that the amended partnership agreement was probably not reduced to writing until after [redacted], based on the memorandum prepared by the partnership's attorney. However, there is no requirement that it be in writing.

Thus, it appears that [redacted] and [redacted] modified the original partnership agreement. However, there is a question concerning whether [redacted] had a [redacted] percent profits interest or a [redacted] percent profits interest at the end of year [redacted]. The [redacted] Schedules K-1 showed in question D that [redacted] and [redacted] each had a [redacted] percent profits interest at the end of [redacted].

We do not believe that this [redacted] percent profits interest for [redacted] and [redacted] on the [redacted] Schedules K-1 can be used to show that the parties had not modified their original agreement. The loss allocations and capital contributions during [redacted] and [redacted] are in such disproportionate shares between [redacted] and [redacted] that it appears that the agreement was modified. The question of whether [redacted] had a [redacted] percent capital interest but a [redacted] percent profits interest is addressed in Issue 3.

We note that before 1976, in general, sections 704(a) and 761(c) gave partners who were partners during the same period the power to allocate partnership gain or loss for that period among themselves without reference to section 706(c)(2). Congress, in the Tax Reform Act of 1976, made a change in section 706(c)(2)(B) to preclude the selling or trading of retroactive allocations of partnership gain or loss.

The 1976 changes are discussed in W. McKee, W. Nelson, and R. Whitmire, Federal Taxation of Partnerships and Partners, paragraph 11.04[1], at 11-14 through 11-16 (1977). It is stated that the changes were intended to prevent retroactive allocations upon the admission of a new partner. However, the language used is arguably broad enough to prohibit retroactive allocations among contemporaneous partners as well. It is concluded, "Notwithstanding the apparent support for these arguments in the statutory language, it seems that they should be rejected and the statutory changes should be limited to specific abuse at which they were aimed - retroactive allocations to newly admitted partners." We agree that the 1976 amendments do not give us any support to attack the oral modification, especially for year [redacted].

We agree with your conclusion that if the oral modification is not given effect, then the partnership will probably be successful in arguing that the original partnership agreement does not have substantial economic effect under section 704(b). Thus, the allocations must be made in accordance with the partner's interest in the partnership.

It appears that neither the original nor the amended partnership agreement has "economic effect" under Treas. Reg. § 1.704-1(b)(2)(ii) because the agreement does not provide for the determination and maintenance of the partner's capital accounts in accordance with the rules of Treas. Reg. § 1.704-1(b)(2)(iv) and there is neither an obligation to restore a deficit balance in the capital account nor a "qualified income offset." Therefore, Treas. Reg. § 1.704-1(b)(1)(ii) provides that because it is for a taxable year before [redacted], the allocation will be respected under section 704(b) if such allocation has substantial economic effect or is in accordance with the partners' interests in the partnership as these terms have been interpreted under relevant case law, the legislative history of section 210(d) of the Tax Reform Act of 1976, and the provisions of the regulations in effect for partnership taxable years before [redacted]

We agree with your conclusion that under relevant case law a court would allow the allocation made by the partnership. Further, we do not believe that it would be appropriate for the Service to argue in court that the original agreement should apply under these facts, especially when [redacted] has made such capital contributions and the modified agreement more clearly reflects the partners' interests in the partnership. The purpose of section 704(b) is to have the tax benefits and burdens follow the economics of the transaction and not allow the partnership agreement to control if it does not have substantial economic effect.

ISSUE 2 - TEFRA Small Partnership Exception.

The unified partnership audit and litigation procedures of sections 6221-6233 ("TEFRA") apply to "partnerships" as defined by section 6231(a)(1). Section 6231(a)(1)(B) provides for an exception to the application of TEFRA procedures for certain small partnerships as follows:

(B) Exception for small partnerships -

(i) In general. - The term partnership shall not include any partnership if -

(I) such partnership has 10 or fewer partners each of whom is a natural person (other than a nonresident alien) or an estate, and

(II) each partner's share of each partnership item is the same as his share of every other item.

For purposes of the preceding sentence, a husband and wife (and their estates) shall be treated as 1 partner.

In the recent decisions of Z-Tron Computer Research and Development v. Commissioner, 91 T.C. 258 (1988) and Harrell v. Commissioner, 91 T.C. 242 (1988), the Tax Court set forth a "bright line test" for determining whether the same share requirement has been satisfied. The "bright line test" provides that each partner's share of each partnership item is determined by examining the partnership return and Schedules K-1 (and any amendments filed prior to the commencement of the audit), considering only those items reported for the year in issue. The determination of this requirement should be made by the Service as of the date of the commencement of the audit. See Z-Tron, 91 T.C. at 262; Harrell, 91 T.C. at 246.

One of our concerns regarding the "bright line test" is that it conflicts with the temporary regulations, which provide in pertinent part as follows:

> If each partner's share of each partnership item would be the same as the partner's share of every other item, but for allocations made under section 704(c) or allocations made under similar principles in accordance with the regulations, the same share requirement of section 6231(a)(1)(B)(i)(II) shall be considered satisfied. Similarly, specified basis adjustments pursuant to sections 754, 743 and 734 shall not be taken into account in determining whether the same share requirement is met.

Temp. Treas. Reg. § 301.6231(a)(1)-1T(a)(3). Any of these above listed special allocations or basis adjustments will bring a small partnership back into the small partnership exception, and the TEFRA procedures will not be applicable.

The temporary regulations conflict with the "bright line test" in that it generally will not be readily apparent from the partnership return and the Schedules K-1 whether any special allocations pursuant to section 704(c) have been made. If the Tax Court test is followed, a partnership may be excluded from the small partnership exception, whereas under the temporary regulations, the partnership would still be within the exception.

We have reconciled the "bright line test" and the inconsistency with the temporary regulations by recommending that revenue agents first apply the "bright line test". If any disproportionate allocations are identified, a facts and circumstances test should be applied to determine if the disproportionate allocations are due to section 704(c) (or similar principles), or because of basis adjustments pursuant to sections 754, 743 or 734. If the disproportionate allocations are due to any of the above-listed sections, then the same share requirement is not violated and the deficiency procedures should be followed. On the other hand, if the exception to the same share requirement set forth in the temporary regulations is inapplicable, the TEFRA procedures should be followed.

It is our opinion that the "bright line test" requires revenue agents to look at each item shown on the return and Schedules K-1, and determine if each reported item was allocated in accordance with the proper percentages; the agents cannot simply look at Question D of the [redacted] Schedules K-1 (or the appropriate question on the Schedules K-1 for other years) showing percentages of profits and losses.

You stated in your request that if the Service takes the position that the written partnership agreement controls, the partnership would come within the small partnership exception because the agreement provides that the net profits and net losses shall be shared equally. Conversely, you stated that if the Service concedes that the written partnership agreement was orally amended to provide that losses are allocated on a [redacted] ratio and gains are shared on a [redacted] ratio, the same share requirement would not be met. However, under Z-Tron and Harrell, in determining whether there are any disproportionate allocations, the Service must examine the partnership return and Schedules K-1. The primary factor that the Service must consider is the actual allocation noted on the Schedules K-1 notwithstanding the fact that the partnership agreement specifies that the net profits and net losses are to be allocated in a different manner.

In the [redacted] partnership return, there were [redacted] items reported for the [redacted] taxable year. The partnership showed a loss and a capital gain. The loss was shared and allocated among the [redacted] partners in the same ratio as their partnership interests ([redacted]). The capital gain, however, was reported in the entire amount by one partner. Accordingly, under the "bright line test" there were disproportionate allocations. The facts and circumstances must be analyzed to determine if the disproportionate allocations were due to any allocations under 704(c).2/

2/ It appears that the basis adjustments exceptions under sections 754, 743, and 734 would not be applicable in this case.

ISSUE 3 - Profits Interest for Services.

In considering this issue, it is first necessary to determine what [redacted]'s interest in the partnership is for taxable year [redacted] under the partnership agreement and the effect of the oral modification. In Issue 1, we determined that the oral modification should be given effect. There exists a question whether [redacted] had a [redacted] percent profits interest as provided in the written amended partnership agreement or whether [redacted] had a [redacted] percent profits interest as shown on the [redacted] Schedule K-1.

The burden of proof to show that his profits interest in [redacted] is not [redacted] percent will fall on [redacted]. We do not know what evidence or testimony that [redacted] would put forward. However, we anticipate that the accountant and [redacted] who signed the Form 1065, will state that it was an inadvertent mistake based on the original partnership agreement in which both [redacted] and [redacted] had a [redacted] percent interest. Further, the revenue agent states that [redacted] contributed capital of $[redacted] in [redacted] while [redacted] furnished $[redacted]. Thus, a court may believe that the partners had not intended a [redacted] percent profits interest for [redacted] and that [redacted]'s services were not of sufficient value to warrant such a large profits interest in view of [redacted]'s disproportionate share of the capital contribution.

However, for purposes of this Tax Litigation Advice memorandum, we will assume that [redacted] had a [redacted] percent capital interest in the partnership but a [redacted] percent profits interest. You ask how that [redacted] percent profits interest should be valued for [redacted].

While the regulations are clear that a service partner is taxable on the value of a partnership capital interest received for services, the tax treatment of a partner who receives only a profits interest is not clear. Treas. Reg. § 1.721-1(b)(1) provides, in part, "To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply.

Before Diamond v. Commissioner, 56 T.C. 530 (1971), aff'd 492 F.2d 286 (7th Cir. 1974), it was generally assumed that the receipt by a service partner of an interest solely in future partnership profits was not a taxable event. However, in Diamond, the Tax Court and the Seventh Circuit held that a service partner is taxable on the value of an interest in partnership profits received in consideration for services.

The Diamond decision has caused much controversy. Although there is general agreement that an interest in partnership profits is "property," there is disagreement on the proper method concerning valuation of that property.

In G.C.M. 36,346, I-176-75 (July 25, 1977), the Diamond case was considered. That memorandum notes that the Diamond decision has been widely criticized because it creates serious valuation problems. The memorandum concludes that the Service will not follow Diamond to the extent that it holds the receipt of an interest in future partnership profits as compensation results in taxable income. The memorandum generally preserves the result in Diamond, however, by concluding that most of the interest at issue in Diamond was an interest in capital, not profits. The memorandum emphasizes that the service provider who receives a nontaxable profits interest must be a partner rather than an employee or independent contractor. Further, a nontaxable profits interest is limited to an interest that gives the holder no rights to existing partnership assets on the liquidation of his interest. Attached to the memorandum is a proposed revenue ruling that states that such profits interest is analogous to an unfunded, unsecured promise to pay deferred compensation to someone other than a partner which is not property under section 83. See Treas. Reg. § 1.83-3(e). However, the proposed revenue ruling was never published and contrary positions have been proposed since G.C.M. 36,346 was issued.

However, case law applied since Diamond does not appear to provide support for charging [redacted] with taxable income in [redacted] for this profits interest. In St. John v. United States, an unpublished opinion, 84-1 U.S.T.C. ¶ 9158 (C.D. Ill. 1983), the District Court distinguished the taxpayer's case from Diamond. The District Court stated that in Diamond it was clear that the interest involved did have a value since within 30 days of receipt of the interest, it was sold for $40,000. In St. John, the taxpayer had received a 15 percent profits interest presumably for services but would receive nothing until the other partners had recouped their cash contributions of $170,000. Turning to section 83, the District Court stated it must determine the interest's fair market value on the day the substantial risk terminated. The District Court focused primarily on the interest's liquidation value, which, because of the interest's subordination to the capital interests of the other partners, was zero. In addition, the partnership was engaged in a speculative business. The District Court held that the taxpayer's interest had no value. See also Kenroy, Inc. v. Commissioner, T.C. Memo. 1984-232, which appears to have accepted the rationale expressed in St. John.

If the partnership liquidated on the last day of [redacted] in the instant case, it appears that [redacted] would receive nothing based on his [redacted] percent profits interest. Thus, it does not appear that his profits interest was, in fact, a disguised capital interest. Therefore, in accordance with G.C.M. 36,346, we recommend that [redacted] not be charged with taxable income in [redacted] for the receipt of an interest in the future profits of the partnership.

We responded in a manner that is favorable to the taxpayer in two of the three issues. However, we caution that a taxpayer has a right under Rev. Proc. 89-2, 1989-1 I.R.B. 21 to request technical advice from the Associate Chief Counsel (Technical) concerning matters involving the examination of a taxpayer's return. A request for Tax Litigation Advice is not a substitute for that revenue procedure, and this memorandum is not to be used to deprive the taxpayer of its right to request technical advice from the Associate Chief Counsel (Technical).

If you have any questions concerning these matters, please contact Harve M. Lewis at FTS 566-4189.

MARLENE GROSS

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